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CITY OF LODI, CALIFORNIA

Report to City Council

For the Year Ended June 30, 2009

Mgt. Ltr.
12/24/09

CITY OF LODI, CALIFORNIA
Report to City Council
For the Year Ended June 30, 2009

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MACIAS GINI & O'CONNELL LLP
Certified Public Accountants & Management Consultants

SACRAMENTO
3000 S Street, Suite 300
Sacramento, CA 95816
916.928.4600

WALNUT CREEK

OAKLAND

LOS ANGELES

NEWPORT BEACH

SAN MARCOS

SAN DIEGO

City Council
City of Lodi, California

We have audited the financial statements of the City of Lodi, California (City) for the year ended June 30, 2009, and have issued our report thereon dated November 9, 2009. Professional standards require that we provide you with information related to our audit. That information is included in the Required Communications section of this report.

Also, in planning and performing our audit of the financial statements of the City for the year ended June 30, 2009 we considered the City's internal controls in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements, and not to provide assurance on internal control over financial reporting.

During our audit for the fiscal year ended June 30, 2009, we became aware of a certain matter that represents an opportunity for strengthening the City's internal control and operational efficiency. The Current Year Management Comment and Recommendation section of this report summarizes our comment and recommendation regarding the matter. We also followed up on those matters we became aware of during the previous years' audits. Those matters are included in the Status of Prior Year Recommendations section of this report. This report does not affect our report dated November 9, 2009, on the basic financial statements of the City.

This letter is intended solely for the information and use of City Council and management and is not intended to be and should not be used by anyone other than these specified parties.

We would like to thank the City's management and staff for the courtesy and cooperation extended to us during the course of our engagement. We have discussed our comments and suggestions with management and would be pleased to discuss them further.

Macias Gini & O'Connell LLP

Certified Public Accountants

Sacramento, California
November 9, 2009

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Required Communications
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Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note 1 to the financial statements. No new accounting policies were adopted, other than GASB Statement No. 45, *Accounting and Financial Reporting by Employers of Post-employment Benefits Other than Pensions* and GASB Statement No 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*.

The adoption of GASB 45 required the City to include a disclosure on its other post-employment benefits (commonly referred to as OPEBs) in its notes to the financial statements consistent with that disclosure already required for pensions. The adoption of GASB 45 also had two significant impacts on the City's financial statements. Historically, the City followed guidance provided by GASB Statement No. 16, *Accounting for Compensated Absences*, to account for its liabilities for sick leave benefits. A significant portion of the sick leave benefits is now accounted for under GASB 45, which is different than that under GASB 16. GASB 45 does not require the immediate recording of the liability. As a result, the City's beginning net assets were increased by \$4,777,701. GASB 45 requires a liability to be recorded only when the actual payment is less than the actuarially determined annual required contribution. For 2009, that required contribution was determined to be \$1,785,173, however the City's actual pay-as-you-go cost was just \$589,652. Therefore, the City has recorded a net OPEB obligation of \$1,195,521 as of June 30, 2009.

The adoption of GASB 49 required the City to record as a liability its estimated pollution remediation obligations. The City estimated those obligations to be \$70,505,924 as of June 30, 2008. As a result, the City's beginning net assets were decreased by this amount. The City estimated those obligations decreased to \$69,952,135 as of June 30, 2009. As a result, the City's long-term liabilities now include this amount.

The application of existing policies was not changed during the year ended June 30, 2009. We noted no transactions entered into by the City during the year for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a different period than when the transaction occurred.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

- The self-insurance liability is based on the development of amounts from various consultants' actuarial studies.
- The net OPEB obligation is based on an actuarial analysis.
- The pollution remediation obligation is based upon estimated cash flows determined by an engineering consultant's remedial action plan.

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- The actuarial pension data contained in Note 10 to the financial statements and required supplementary information (unaudited) is based on actuarial calculations performed in accordance with the parameters set forth in GASB Statement No. 50 and GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*.
- The actuarial data for other postemployment benefits contained in Note 11 to the financial statements and required supplementary information (unaudited) is based on actuarial calculations performed in accordance with GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

We evaluated the key factors and assumptions used to develop these estimates in determining that they are reasonable in relation to the financial statements taken as a whole.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. Management has corrected all such misstatements. The following material misstatement detected as a result of audit procedures was corrected by management:

Special item – swap termination	\$8,979,000
Interest expense	\$ 374,125
Deferred charges	8,604,875

To expense the swap termination payment as a special item that was originally recorded as a deferred charge (asset) in the Electric Fund and was being amortized through interest expense.

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of the audit.

Management Representations

We have requested certain representations from management that are included in the management representation letter dated November 9, 2009.

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Management Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the governmental unit's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or Issues

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the City's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

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Current Year Management Comment and Recommendation
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AMERICAN RECOVERY AND REINVESTMENT ACT (ARRA)

The American Recovery and Reinvestment Act of 2009 (the Recovery Act) provides approximately \$300 billion dollars in additional federal funds which will be passed down from federal agencies to state and local governments and institutions of higher education. These federal funds are intended to either supplement existing federal programs, create new programs, or to provide more broad fiscal relief.

The Recovery Act mandates that there be an unprecedented amount of oversight and transparency over the spending of all funds associated with it. The Office of Management and Budget (OMB) set up a web site to be the central point for the transparency part of the mandate. Also, the OMB issued guidance to the federal agencies regarding how they should carry out programs and activities relating to the Recovery Act that promotes timeliness and accountability. The OMB guidance addresses many issues and responsibilities including the following:

- Recipients are generally required to clearly distinguish Recovery Act funds from non-Recovery Act funds.
- New programs or existing programs that have significant changes in compliance requirements will be identified with a new Catalog of Federal Domestic Assistance (CFDA) number.
- Federal agencies designated Recovery Act programs as high-risk for single audit purposes.
- There is extensive quarterly reporting to federal agencies required from recipients of Recovery Act funding, which will be due within 10 days of each calendar quarter-end.
- Federal agencies are required to initiate additional oversight to address the unique implementation risks of the Recovery Act. The expectation in this area is that federal agencies will establish defined strategies to prevent or timely detect waste, fraud, or abuse.
- Federal agencies will also use the single audit process as a means of promoting accountability for Recovery Act funds.
- The Federal Audit Clearinghouse (FAC) is also required to make publicly available on the internet all single audit reports filed with the FAC for fiscal years ending September 30, 2009, and later.

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Based on the information above, it is clear the Recovery Act funds will have a significant impact on your single audit. While the Recovery Act may not have an immediate impact on your June 30, 2009 single audit, it is likely that it will have a significant impact over the following two fiscal years. Therefore, the City should begin planning and assessing risks associated with the receipt, spending and reporting of Recovery Act funds. Specifically, you should consider the following:

- Whether control procedures in place over federal expenditures are appropriate, operating effectively, designed to detect and prevent unallowable expenditures, and designed to detect or prevent fraud and abuse.
- Whether the existing staffing resources are adequate to address the increased reporting and monitoring requirements as a result of the Recovery Act. Also, the City should identify individual(s) who will monitor requirements and provide consistent guidance to the organization.
- Whether additional controls and system requirements will be needed to ensure that Recovery Act funds can be separately identified and tracked.
- Whether new controls will need to be established to meet the stringent reporting requirements to federal agencies.

If Recovery Act funds will be passed down to subrecipients, that controls are in place to ensure appropriate subrecipient monitoring and also whether any new controls will need to be established related to new subrecipient reporting responsibilities.

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Status of Prior Year Recommendations
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The following is a summary of the status of prior years' recommendations.

FROM YEAR ENDED JUNE 30, 2008 -

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (CalPERS) ENROLLMENT

Condition

During our audit, we noted that one part-time employee exceeded 1,000 hours during fiscal year 2002. However, based on our review of the Personnel Action Form (PAR) in the part-time employee's personnel file and the CalPERS' online database, the part-time employee was enrolled in CalPERS nine months later. For employees enrolling in CalPERS, the requirement is that they be enrolled once they exceed 1,000 hours in a given fiscal year. However, it appears that the City has the option of not enrolling part-time employees.

Recommendation

It is recommended that Human Resources determine what happened in this instance and that the necessary changes in the payroll and timekeeping system, as well as review the manual payroll controls that compliment the enrollment notification process, are developed to ensure that the CalPERS enrollment process is done timely for eligible employees.

Current Year Status

We performed testing over the participant data file and noted no errors relating to the enrollment dates of the randomly selected participants. Therefore we consider this finding resolved.

FROM YEAR ENDED JUNE 30, 2007 -

INTERNAL SERVICE FUNDS

Condition

Internal service funds are expressly designed to function as *cost-reimbursement devices*. That is, an internal service fund is simply a means of accumulating costs related to a given activity on an accrual basis so that the costs can subsequently be allocated to the benefiting funds in the form of fees and charges. During our audit of the City's financial statements for the period ending June 30, 2007, we noted that the internal service fund does not appear to be recovering the full cost of providing medical insurance benefits to other funds and/or user departments.

We examined, on a test basis, monthly CalPERS invoice billings of health insurance premiums for active participants enrolled in the health care plans offered by CalPERS, the cost of which were expensed in the internal service fund, however, the revenue reported by the internal service funds were consistently less than the related costs of the medical benefits provided. Absent a reconciliation of the enrolled participants in the CalPERS health care plans and the City's internal payroll and Human Resources system, the costs related to the CalPERS invoice billings of health insurance premiums could be permanently stranded in the internal service fund, and therefore, the user departments not being charged their proportionate share of the costs.

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Status of Prior Year Recommendations (Continued)
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Recommendation

We encourage management and/or authorized employees to perform a monthly reconciliation of the enrolled participants in the health care plans as reported by CalPERS in the monthly health insurance invoice roster detail with the City's internal payroll system and HR records to ensure accuracy and completeness of the roster. This strengthens control and ensures that the costs are properly and timely allocated according to the user department or fund and that City is only being charged for current employees at authorized rates.

Current Year Status

Condition unchanged. Recommendation remains.

Current Year Management Response

Procedures have been developed and will be fully implemented in fiscal year 2009-10.

FROM YEAR ENDED JUNE 30, 2005 -

ENVIRONMENTAL REMEDIATION

Condition

The Governmental Accounting Standards Board (GASB) issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*, in November 2006. The requirements of this Statement are effective for financial statements for periods beginning after December 15, 2007, with measurement of pollution remediation liabilities required at the beginning of that period so that beginning net assets can be restated.

Recommendation

With the City's ongoing environmental contamination remediation issue, we recommend that the City be aware of and review this new future GASB standard and ensure that the City be positioned to implement this standard when it becomes effective.

Current Year Status

GASB Statement No. 49 – *Accounting and Financial Reporting for Pollution Remediation Obligations* has been implemented for the fiscal year ending June 30, 2009. Therefore we consider this finding resolved.

INFORMATION TECHNOLOGY (IT)

Information Technology Administration – Policies and Procedures

Condition

Administrative policies and procedures exist covering certain areas of IT, but lack sections dealing with network security, password protection and configuration, and confidentiality of information.

Recommendation

The City should consider appending the current administrative policies and procedures to include sections pertaining to computer network security, password protection and configuration, and confidentiality of information.

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Current Year Status

A new Electronic Media Acceptable Usage Policy has been adopted for use within the City. A review of the policy found that it does address computer network security, password protection and specific configuration standards, and confidentiality of information. Therefore we consider this finding resolved.

Logical Security – Departing Employees

Condition

There is not an official policy and associated procedures outlining the timely notification of the network and applications managers of a departing employee, contractor or temporary worker. Disabling or removing the accounts of inactive users in a timely manner is essential to inhibit malicious activity on the computer systems.

Recommendation

The City should develop an official policy and procedure to ensure that the network manager and the financial application managers are notified in a timely manner whenever there is a departing employee, contractor or temporary worker with an active user account to the computer systems.

Current Year Status

The City has adopted a policy to ensure that the network manager and the financial application managers are notified in a timely manner whenever there is a departing employee, contractor or temporary worker with an active user account to the computer systems. We noted that the Information Systems (IS) Division conducted an audit of all user accounts to ensure that only current and valid personnel have access. Therefore, we consider this finding resolved.

Logical Security – Access Rights

Condition

There is no policy and procedure to ensure that all system and application access rights are authorized and up-to-date. All users must complete a written application, signed by their supervisor, the respective department head and IS Manager, in order to be issued a user account for the AS400 or any systems hosted by the IBM. The user accounts remain active until revoked. While this addresses the initial issuance of user accounts and their associated authorization level, it does not address the control objective of ensuring that all access rights are up-to-date. Personnel may move between positions wherein the authorizations for those positions are not the same. Currently, reviews only check for obsolete accounts and do not address existing accounts for appropriateness.

Recommendation

The IS Division should establish procedures to periodically review the lists of system and application users to ensure that access rights are authorized and up-to-date. In addition, the process for approving authorization to access the financial application should be reviewed to ensure that only authorized persons are given the proper access to the system. This could include a review of persons by the Director of Finance.

Current Year Status

User lists are periodically reviewed by the IS Division to identify obsolete accounts and user appropriateness. In addition, department heads are annually sent a list of users within their departments and their access rights. The Deputy City Manager is also sent a list for review. A policy has been adopted that formally incorporates procedures to be performed. Therefore, we consider this finding resolved.

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Accounting System Development and Maintenance

Condition

While most procedures for the accounting system development and maintenance are in place, they are not formally documented. Having the policies, procedures and standards formally documented should address any ambiguity in implementation and reliance upon only a few key individuals.

Program changes are not always initiated, tested and approved by the functional users before being applied to the production system.

The IS Division Programmer is not restricted from making changes in the production environment and is also responsible for transporting changes and updates from the test environment to the production system.

Recommendation

Official policies, procedures and standards for the accounting system development and maintenance should be documented and maintained. These policies, procedures and standards should ensure that:

- All new programs and changes are initiated and approved by the appropriate user management.
- The impact of new programs and updates are assessed in a test environment before implementation in the production system.
- Programmers do not have update access to the production system, except for emergency fixes.
- Any emergency fix in the production system is properly logged.
- Program testing is reviewed and approved by someone other than the programmer.
- The process of moving programs into the production system is formal, well documented, and performed by someone independent from programming.

Current Year Status

Condition unchanged. Prior recommendation remains. This is in process of being implemented. The IS Division has drafted a formal change control policy that incorporates procedures and standards as recommended, to ensure program changes applied to major systems follow an appropriate methodology and minimizes the risks associated with the continued operation without the proper change management oversight that include the inadvertent alteration or deletion of financial data or having the financial system unavailable for an extended period of time.

Current Year Management Response

Management agrees. Formal policies covering this recommendation should be implemented during fiscal year 2009-10.

Packaged Accounting Software and Systems Software – Selection Method

Condition

There is not currently a documented system and application software selection method outlined for the City.

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Recommendation

The City should document their system and application software selection processes and ensure that the following areas are addressed:

- Business needs,
- Technical requirements,
- Analysis/comparison of several products
- Implementation issues, including conversion, and
- Cost/benefit analysis

The City should pursue the needs assessment for the new financial and billing system as noted below, but the procedures for system and application acquisition should be documented.

Current Year Status

Condition unchanged. Prior recommendation remains. This is in process of being implemented. Formal policies are in process of development.

Current Year Management Response

Formal policies covering this recommendation should be implemented during fiscal year 2009-10.

Packaged Accounting Software and Systems Software – Test Environment

Condition

The IS Division has implemented a test environment for application software, but not for system software. Update and patches are being applied directly to the production system.

Recommendation

Procedures to test updates to system software should be implemented, either on a separate machine or as a partition with the current AS400, to ensure that updates and upgrades are not applied directly to the production system without proper testing beforehand.

Current Year Status

Condition unchanged. Prior recommendation remains. This is in process of being implemented. The IS Division has drafted a patch management policy documenting the process for applying patches and updates for operating systems and applications that follow the current change control draft policy and procedures.

Current Year Management Response

Management agrees. Formal policies covering this recommendation should be implemented during fiscal year 2009-10.

Computer Operations – Computer Room

Condition

The City has moved the computer room which now has a separate dedicated air conditioning system, Uninterrupted Power Supply (UPS) and generator. The room is secured with standard lock and key controlled by the IS Division staff and facilities maintenance. An intrusion alarm system and temperature and water alarms have been installed and are monitored by a local security company. The room is equipped with a sprinkler system for fire suppression.

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Recommendation

The IS Division should consider replacing the water sprinkler system with a dry fire suppression system. If local building ordinance requires the use of a water based system, the City should consider a dual system with a pre-action type sprinkler.

Current Year Status

Condition unchanged. The City remains at risk of loss of financial data and information technology assets due to water-based fire suppression system in the computer room. The City's actions to mitigate the risk were to implement a disaster preparedness/business continuity plan (see following comment).

Current Year Management Response

The City has determined that the risk to the IT equipment is acceptable given the cost of re-fitting the computer room.

Computer Operations – Disaster Preparedness/Business Continuity Plans

Condition

The City currently has no disaster preparedness or business continuity plans in place.

Recommendation

The City should work to develop a comprehensive disaster preparedness and business continuity plan. The plan, upon completion, should be thoroughly tested and provisions made for periodic reviews of the plan.

Current Year Status

In the process of being implemented. Due to budgetary constraints, the City did not renew its contract with IBM Business Partner to provide disaster recovery services including recovery equipment hosting and priority equipment replacement. The City is now performing its own disaster recovery by doing two nightly backups on tapes and one weekly full backup. One copy of the nightly backup is stored in the IS Division and another copy in the Police Department building. Although best practices recommend that the backup tapes be stored at least 20 miles from the primary data center, the City has no plans to change the secondary storage site. This puts the City at increased risk of losing financial information as the backup tapes are subject to many of the same environmental risks as the primary data center, such as floods, large fires or earthquakes. Additionally, the City's disaster recovery plan has not been fully tested.

Current Year Management Response

Management agrees. The City has received grant money to update certain hardware and software that will allow high level of system and data redundancy and to fully test the plan by December 31, 2010.

Computer Operations – Service Level Agreements

Condition

Service level agreements between the IS Division and the user departments are not in place. Help-desk services are provided, but without documented policies and agreements, an acceptable level of service cannot be properly defined.

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Status of Prior Year Recommendations (Continued)
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Recommendation

Service level agreements between the user departments and the IS Division should be instituted to define the level of service to be expected.

Current Year Status

In process of being implemented. Prior recommendation remains.

Current Year Management Response

Service level agreements are being drafted and are expected to be completed during fiscal year 2009-10.

Computer Operations – Unauthorized Use of Software

Condition

There are no procedures in place to ensure that there is no unauthorized use of software within the City.

Recommendation

The IS Division should institute official procedures for the review of software installed on computers at least yearly. The City should make efforts to protect itself from the liability of employees using unauthorized software. An alternative to the physical review of installed software is to require administrator privileges on network computers in order to install any software.

Current Year Status

In the process of being implemented. The City has elected the alternative by requiring administrator privileges on network computers in order to install any software. However, the number of users with local administrative rights has increased as a result of the Police Department installing a CAD RMS system in June 2009. The system requires users to have local administrative rights for it to operate properly. Approximately 100 computers in the Police Department have local administrative rights. The IS Division is in the process of developing a way to restrict the local administrative rights on these computers without affecting the system's functionality.

Current Year Management Response

Management agrees. The IS Division is still in the process of restricting local administrative rights on the Police Department computers. As of November 1, 2009, all but five of the Police Department computers have had their local administrative rights restricted. It is expected that all computers will have their local administrative rights restricted by December 31, 2009.

Other Matters

Since 2005, the City has been in various stages of addressing our prior recommendations. Efforts to implement several have been hampered by budgetary constraints and other higher priority undertakings. Overall, of the 10 IT findings and recommendations from our 2005 review that remained last year, three have been implemented and seven are in the process of being implemented. Several of the recommendations in the process of implementation will be completed before the end of fiscal year 2009-2010.

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FROM YEAR ENDED JUNE 30, 2004 -

CAPITAL ASSETS

Condition

During our audit of the City's financial statements for the year ended June 30, 2004, we noted that the acquisition and construction of capital assets is maintained on a spreadsheet, outside of the City's accounting system, which can lead to inaccurate recording and depreciation of capital assets.

Recommendation

We recommend that the City place into operation the JDE fixed asset module that records the City's capital assets and automatically calculates depreciation. The system would support the City's depreciation method and automatically post accumulated depreciation expense to the General Ledger module for a specified accounting period.

The system provides methods to track assets, their beginning cost, current value, and method of depreciation. Some of the advantages include:

1. Flexible Asset Numbering System – an unlimited number of assets can be maintained. The assets can be grouped by many types of categories for reporting purposes.
2. User Defined Asset Control - Accumulated depreciation, depreciation expense and asset master accounts can be user specified for each asset.
3. Reports - variety of reports can be produced including a listing of all assets by type, category and description, method of depreciation, and all other information maintained in the master file. The module could be programmed to also print reports listing assets with original cost and current book value plus calculated depreciation for a specified period.

To reduce operating overhead, the City should consider hiring temporary staff for data entry into the capital assets module.

Current Year Status

Condition unchanged. Prior recommendation remains.

Current Year Management Response

Finance is currently in the initial stage of assessing the magnitude of this project and coordinating with Information Systems Division to evaluate and establish a project plan. As of fiscal year 2008-09 the City does not have the resources to do so.

FEDERAL TRANSIT ADMINISTRATION INDIRECT COSTS

Condition

We noted, during our review of the fiscal year 2003/2004 Federal Transit Administration (FTA) apportionment, that management had originally decided to use the apportionment to cover indirect costs. Per our review of FTA guidelines, grantees who intend to seek FTA reimbursement for indirect costs must prepare a cost allocation plan that has been approved by the FTA or another cognizant Federal agency. Further inquiry determined that the cost allocation plan has not been approved in the prescribed manner.

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Recommendation

We recommend that the City perform a review of all grants and make the determination if indirect costs can be applied against grant funds.

Current Year Status

Condition unchanged. Prior recommendation remains.

Current Year Management Response

The City will be issuing a Request for Proposals in fiscal year 2009-10 to secure consultant services to develop an A-87 compliant cost allocation plan and indirect cost rate and secure cognizant agency approval.